Developments in the Hungarian debt markets

György Sándor

1. Introduction

The motives behind the development of the debt markets in Hungary are diverse and have changed over time. Initially the stimulus came from concerns about rollover risk and exchange rate risk for the Treasury. In the second half of the 1990s monetary policy considerations about the information content of the yield curve and concerns about the transmission mechanism added impetus to the development of the debt markets. More recently financial sector stability and convergence-related issues have become important and these might finally facilitate the evolution of a well functioning corporate bond market. An additional boost for debt markets may come from the development of derivatives markets, especially interest rate derivatives, after the lifting of all remaining restrictions on capital account transactions. However, some legal hurdles, eg in the case of repos, remain.

2. The government securities market

The Hungarian government securities market is now a developed and mature market, one of the most liquid and sophisticated in the region. The two most important driving forces were the need to reduce rollover risk and the need to mitigate exchange rate risk for the Treasury. The former required the lengthening of the maturity spectrum of government bonds while the latter called for the issuance of local currency denominated bonds. Monetary policy considerations pushed for fixed income issues. Due to these very strong motives the Hungarian government securities market developed impressively in the 1990s.

In 1988 the central bank began to auction three-month Treasury bills. Currently, Hungarian government bonds are issued for five benchmark maturities, namely two years, three years, five years, 10 years and 15 years, by the Government Debt Management Agency. The first auction of the two-year and three-year fixed rate bonds was in 1996. The new 15-year fixed rate bond was issued in November 2001. The average maturity of auctioned securities was between three and six months in 1994 while it is 2.3 years currently (four months for T-bills and almost three years for marketable government bonds). All marketable bonds issued since 1 April 1999 have been dematerialised.

In the early 1990s private placements of government bonds were common, with no data disseminated on the winning price or any other detail of the terms and conditions. Auctions have become a regular and frequent technique since March 1996. The transparency of the primary market has been improved by regular dissemination of an issuing calendar.

Currently the issuance of government securities is organised through a primary dealer system. The system was established in January 1996 to provide a more secure basis for financing the budget deficit, to reduce financing costs through market mechanisms and to facilitate the expansion and transparency of the secondary market. The basic responsibility of primary dealers is to trade large volumes of government securities with large investors. One of the basic responsibilities and exclusive rights of primary dealers is to bid regularly at auctions. However, their most important obligation is to quote two-way (bid and offer) prices to ensure the liquidity and transparency of the secondary market.

The typical auction size is HUF 15-25 billion (around €50-90 million). The total issue size is typically HUF 100-150 billion (€350-550 million). Turnover has increased since the full liberalisation of the capital account in May 2001. On a typical trading day turnover of government securities is roughly HUF 80-85 billion (about €300 million), which is around 2% of the total outstanding stock of marketable government securities (total HUF 4,200 billion; €17 billion). In 2000 turnover was almost six times the average outstanding stock.

The debt management strategy implies no foreign exchange denominated issuance for 2002. The fiscal deficit and the rollover of former debt will be financed solely from the domestic market.

3. The corporate bond market

While the government securities market is well developed and deep, other debt markets are painfully missing. There are several reasons for this.

- The *macroeconomic situation* was not favourable for the development of fixed income markets. Due to the high and variable inflation, nominal rates varied between 30 and 40% and real rates exceeded 10% in 1995. Subsequently they have fallen back to 10% and 4% respectively.
- As the *exchange rate regime* gained credibility between 1995 and 2001, companies tended to favour foreign currency debt as domestic interest rates were higher than the sum of the preannounced depreciation path and foreign interest rates. Foreign exchange risk was perceived as small, or at least smaller than implied by Hungarian yield premia.
- The *Hungarian privatisation strategy* preferred the sale of state assets to dedicated professional investors and international financial investors on a cash basis and in many cases with a promise of further investments. This led to a situation where the biggest companies financed their investments from retained earnings and/or (foreign currency denominated) loans from their parent companies.
- *Structural problems* also played a role. The lack of sufficient rating agencies and appropriate hedging instruments made corporate bonds very risky. The lack of liquidity led to significant issuance costs and pricing problems. The privatised banks were very agile and innovative in competing for corporate clients, which pushed down the cost of bank funds.

There is anecdotal evidence that with the decreasing interest rates, some financial institutions are considering issuing bonds. It is worth mentioning, however, that it is not obvious that there is a need for a domestic currency denominated corporate bond market as the country marches into EMU. There are fears that the big corporations are going to issue bonds in the euro market.

4. Prospects and policies

One potential driving force for the development of debt markets is the expected growth of derivatives markets. Despite full liberalisation, these markets are still not very liquid though there are signs that interest rate swaps are gaining popularity. The most important segment currently is the foreign exchange swap market. Interest rate derivative products and options only play a marginal role at this point.

Government securities markets may be boosted further if some legal hurdles (such as collateral not being exempt from bankruptcy procedure) are abolished.

Central banks may facilitate the development of debt and derivatives markets by adopting the best international practices for accounting, clearing and settlement, collateral etc. when using these instruments. For example, currently the collateral practices applied in the market are different from those applied by the central bank.